

August 6, 2010

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Current Commentary on the Primary Financial Market Trend

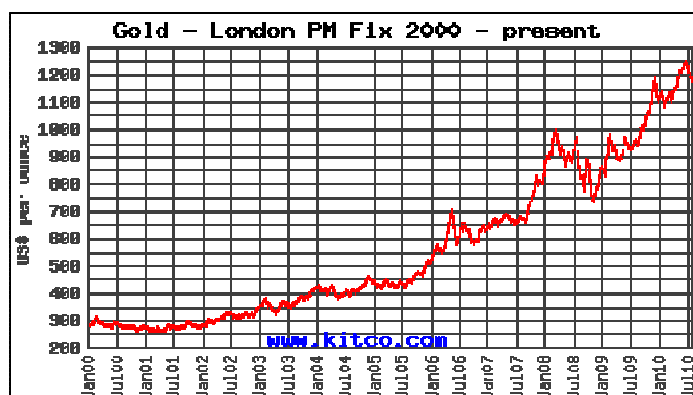
The Weekly Peak

Why Today's Deflation Won't Kill Gold

With all of the attention given to deflation recently, I thought it might be interesting to think about how this scenario could affect gold. After all, gold is thought to be the ultimate investment in a time of inflation. Does this mean deflation will destroy the value of gold?

More interesting than the question, in my view, is the road to the potential answer because there simply isn't a clear one. However, based on everything I've read and researched, the outcome is closer to no: **today's deflation will not topple gold.**

1. **Gold's Primary Trend Is Up** – Gold's decade-long chart tells us that if deflation is taking hold, it will not destroy the value of gold. We know this because this chart captures every fundamental possibility including that of deflation and in the face of this possibility, gold's long-term and primary trend remains very clearly up.



However, we must define the word "destroy" because gold will not be immune to deflation or a general decline in prices. In fact, just as the chart above tells us that the primary trend is up, it suggests that gold may decline in value from current levels to about \$900 per ounce or even lower. While this may seem like destroyed value to many, it will not be in relation to any other asset class in this period of deflation. **Gold will be a good store of value in relative terms.**

2. **Today's Deflation Will Bleed Into Hyperinflation** – I believe the chart above is telling us the story of today's *variety* of deflation or the sort that will twist into hyperinflation due to the world's unsustainable 30-year borrowing binge that's been transferred to the public sector, and thus sovereign debt and the underlying currencies, from the private sector. Under these circumstances, gold will be subject to the general decline in prices that will take hold under deflation as discussed above, but on a relative basis, gold will hold value due to the collective desire to hoard one of the oldest and most accepted transferrable stores of value.
3. **Ultimate Hoarding Vehicle** – Sam Hewitt of Sun Valley Gold Company makes the very strong point that in past U.S. deflations, individuals had the choice to hoard either in paper currencies or in gold. "The historical record," according to Mr. Hewitt, "Demonstrates that loss of confidence in the issuer of paper currency is often a sufficient reason for individuals to choose gold over paper currency."

While the conversation about the coming collapse of fiat currencies has become rather popular in many circles more recently, the chart above is telling us that many more people have been having this conversation for at least ten years. **It is not a coincidence that that the run-up in gold occurred as the world's debt storm was completing its final phases.**

I also believe that the chart above is telling us that there have been **many individuals who have been choosing to hoard gold due to a collective lack of confidence in a paper currency that may be pulverized by the U.S. deficit.**

4. **Untarnished Credit Quality** – Another excellent point made by Mr. Hewitt is that when gold is compared to “widely available cash-substitutes, gold’s relative attractiveness boils down to relative credit quality.”

Specifically, “Whenever deteriorating credit conditions negatively impact the issuers of paper currency, investors turn toward gold as the preferred hoarding vehicle. **To predict the future behavior of gold under deflation, one must include the impact of deteriorating credit conditions on the issuers of competing cash-substitutes in today’s markets.**”

In the case of the current credit situation, the tremendous run-up in financial sector borrowing, and GSE borrowing in particular, that could not be sustained by the private sector, is now very squarely on the public shoulders of Uncle Sam. If this borrowing load proves to be unsustainable for the public sector, it will produce weakened Treasuries and a devalued dollar or a deteriorated U.S. credit quality.

Gold, however, is a store of intrinsic value that will not be tarnished by such a crisis. While such a situation may render gold less valuable during the time of the crisis than it is today, it will retain value since it is independent of credit quality.

I would like to point out that all of this is different than seeing gold as a currency which many consider to be the food of traders looking to profit on what had been gold’s run up. Rather, this is viewing gold as a store of value.

This being said, I’ve read reports of businesses and entire areas in mid-Michigan which accept competing currencies including gold.

Being a chartist first and foremost, however, I think the most compelling reason to believe that gold will hold value rather well under deflation is the chart on the previous page. **Gold’s long-term and primary trend is up and strongly so.**

While it is likely to decline from today’s levels, gold will not be toppled relative to where it was just 10 years ago as will most other asset classes. Even if gold declines 20% in value from current levels – a percentage that may feel unacceptably high to some – this decline will be minor in relation to the declines made by nearly, if not all, other asset classes under the throes of deflation.

For this reason of relative value, **gold** may come out of this particular deflation (and hyperinflation) dynamic as **the one and only king.**

Sam’s Stash, Gold, and the S&P

Needless to say, I think **Treasury yields will continue to move down** from current levels. I do not see this move, however, as a product of the deflation that I do believe is going to take hold of our economy.

Rather, I see this move as a response to the collective sense that there’s another shoe, or two, to drop yet. To the extent that deflation is a part of that shoe than sure it’s included but, more so, I’m thinking of **Europe.**

I’m having a really hard time forgetting that just three months ago there was at least one euro-zone country on the brink of bankruptcy and a common currency that appeared poised to follow. Well the near-term chart of the currency or the euro (not shown this week) does tell us that it’s headed for a decline on the heels of its recent rise, and thus suggesting that a shoe shall drop or it may even be a boot.

This view is supported by the fact that **Euribor**, or the interbank lending rate of the euro-zone prime banks, continues **strike 2010-high levels** for most of the borrowing time periods and even after the big B+ given to its banking system by the “stress” tests. The closely watched 3-month Euribor is at yet another new high for 2010 sitting at 0.904% or a level it has not been at since the end of July 2009 when the ECB had just begun lending out record amounts to restore some liquidity.

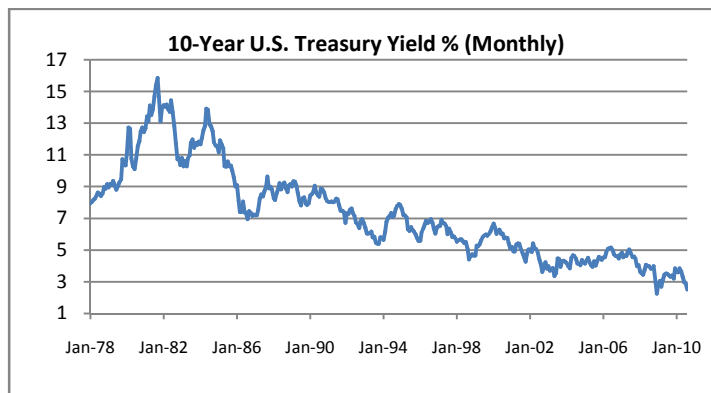
As I’ve been writing each week, remember that Euribor tells us about the **trust, or lack thereof**, among the banks in the euro-zone and the belief that **counter-party risk** exists. Clearly, rising Euribor paints a rather poor picture of each and of that boot.

Bringing this back to Treasuries, however, and I apologize, I simply cannot get Europe off of my mind or the fact that it seems to have disappeared from the minds of so many others, I think there is going to be a flight to safety like we’ve not seen in the financial crisis yet.

This means an investor flock landing the **10-year closer to 2%** and the **30-year closer to 3%.**

Might this coincide with defined drops in the CPI? Yes, but that will not be the cause of the near- to mid-term strength in Treasuries, in my view.

Most importantly, regardless of what it reflects or what its cause might be, the 10-year chart below shows us rather clearly just how defined its downward trend in yield is and thus that 2% level that I've outlined.



On the other side of this strength is that weakness I touched on around the deflation/hyperinflation dynamic and I shall be attempting to explain this one through charts rather soon. Not today however.

Turning to the **dollar**, last week when the dollar index was a bit above 82, I wrote, "Regardless of what happens with the euro, the dollar index is going to 80 and it will be supported nicely there."



And so, now closer to 81 than 80, I believe it will **move closer to 80** and then rest with all of the support found at that level. **I then expect the dollar index to reverse course and start moving back up** and I'll leave it there with that as a "trailer" for next Friday's piece.

Moving back to gold, the one-year chart appears to be decent with a nice, upward-moving slope. However, when scrutinized for technical patterns, it's less positive while that volume, if correct, and I honestly don't know and have no way of checking from this location, is awful.

Similar to GLD, gold gave way to a minor double top last week when it closed at \$1,163/ounce and through the breakpoint of \$1,177/ounce.

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It is my belief that this reflects the market's fears over deflation and the fact that it will lose value even though it will be a much better hold of value than virtually any other asset class. There are other possibilities, but I won't go into them here today.



Instead, I will head straight to what might be considered bad news by some, by anyone who is long gold now and rather odd news for a piece that starts off talking about how it will do well under deflation. Well, this remains true but again it's going to be a matter of relative value.

For as I wrote on the first page, \$900 an ounce appears a possibility. However, I wrote that based off of an "eyeball" of that chart.

Now, I have turned to good charts, really good charts that I unable to show and, on a preliminary basis, I have possibly not-so-great news.

If the confirmed minor double top in gold fulfills itself and hits its target of about \$1,060, it will have passed through the major double top's breakpoint of \$1,066. This means the major double top will be confirmed when the confirmed minor double top fulfills itself, as it is likely to do being confirmed, and it, the major double top, carries a target of between \$900 and \$925.

Interestingly, and this is not the case with GLD, or at least using lesser quality charts, because the confirmation and fulfillment of the two tops are independent of each other.

Will this happen? I admit the dynamic I described above is of a very narrow point range and perhaps this softens its message. However, while you can't see this in the chart above, in the other charts I'm looking at, very excellent charts, the major double top is extremely defined and I don't think it bodes well that its confirmation is connected to the fulfillment of the minor double top that just confirmed.

While I have been staying away from my portfolio, or what I would do, in these weekly pieces, I will point out that I did sell my small GLD position last week when that minor double top confirmed. I would prefer to be on the sidelines as it plays out and either re-enter much higher or at about \$124 with gold at \$1,275 or much lower at about \$90 when gold will be somewhere between \$900 and \$925.

Tying this back into deflation part up front, I hope you will see that even if gold declines to a bit above \$900 from here, its primary trend remains up, I wish I could show you the 10-year version I'm looking at because it is a beauty, and it, gold, will hold value better than any other asset class unless things get really, really bad and in that case we're talking about much more basic assets or things. This, of course, is a discussion for another time.

And now, for the S&P, while I try to keep these weekly pieces focused on the index's long-term chart because I believe it is the only chart that truly matters with its strong downward trend, I am going to touch on the one-year chart today.

I am doing this because it contains what appears to be a 100% valid and near-term bearish pattern that is about as complete as it will ever be and it carries a fast and furious target of about 1,065.

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I am talking about the **Rising Wedge** that I've been writing about for 2 days now. Yesterday's daily piece contains some good points as to why you may want to consider it in this current market environment.



However, in summary, it is a bear market pattern that moves upward through pivot highs and lows until it reaches its apex or where it's at now essentially. It's considered valid when it comes on declining volume and does not make more than a roughly 50% retrace.

It's a favored pattern because when it's valid it **works itself out** and toward its target – in this case, once more, **1,065** or so – quickly as in **hours or days**.

Again, **this Rising Wedge is valid** and I've got to tell you that **I think it's the real deal**. So much so that I am tempted to trade off of it near-term and stop out fast should it not be. More importantly, however, I urge you once again to consider this pattern and **sell equities** if you're long and sit it out in **cash**.

As I wrote yesterday, it's seemed all week that the market's been trading in a way that suggests payrolls will be better than expected, but maybe this wedge is telling us the opposite or of the investor reaction to whatever that report might bring. As luck should have it, we shall know in just a few short hours.

As always, **thank you** for taking the time to read this week's piece.

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